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**Elimination of the Foreign Property
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by

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Elimination of the Foreign Property Rule on Tax Deferred Savings Plans

Joel Fried*

Abstract

The Foreign Property Rule (FPR), limiting the holding of foreign property in pension plan assets, is scheduled to be eliminated this year. It has been rationalized on economic grounds by asserting that it improves the value of the dollar and decreases the cost of capital yet, at the time the FPR began, the government was trying to keep the dollar from rising and there were strong capital inflows. Further, evidence from the past changes in the FPR indicates it had little, if any, affect on the cost of capital and exchange rate, but cost middle income workers between one and three billion dollars per annum when set at 30%. I argue that the reason for its existence was the then common belief that governments could make better economic allocation decisions than markets.

Removing the FPR provides pension plans with greater opportunity for risk adjusted returns as well as responsibilities. Relevant issues that arise include the degree of foreign currency exposure that is desirable and the degree of active management desired in foreign assets, and whether it makes sense to choose fund managers that are regionally focused rather than global. Pension boards will also have to rethink what a Canadian fund is and whether it should mimic Canadian production (as currently structured) or Canadian consumption patterns. An encouraging aspect of eliminating the FPR is the possibility that government ideology is changing to place greater emphasis on the positive benefits of using markets to allocate resources.

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Elimination of the Foreign Property Rule on Tax Deferred Savings Plans

Joel Fried

In the February 2005 budget it was proposed that, effective the beginning of 2005, the Foreign Property Rule (FPR), specifying the maximum proportion of a tax deferred savings plan that could be held in foreign property, be eliminated. No longer would it be necessary for pension funds or individuals to devote 70% or more of their retirement savings to less than 3% of the world's assets. Its establishment was based on two propositions: markets allocate resources poorly, and government is sufficiently wise and benevolent that it must play a leading role in guiding markets toward proper choices. The demise of the FPR comes with the growing recognition that financial markets and the institutions for private pension plans provide the Canadian public significantly better value without the intrusiveness of government in the asset allocation decisions of Canadian savers.

Established in its current form in 1971 where the limit on the book value of assets as foreign property was 10%, there has been a continuous tension between the government's perception of the FPR benefits and those involved in saving for their own, or their plan members', retirement. The rule itself can be considered to be a replacement for a former pension rule requiring that no more than 10% of pension income could be derived from foreign sources.¹ Savers, wanting the diversification gains that come from foreign assets, had begun moving to equities, where much of the return was in the form of capital gains. These were not included in the definition of pension income. The 10% FPR remained until 1990 when the Government announced it was going to increase the maximum level to 20% in annual 2% point increments. This, as well as a regulatory ruling in 1991 that foreign market futures contracts backed by Canadian paper counted as Canadian assets rather than as foreign property reflected pressures from the pension industry to permit greater diversification than was available in the Canadian market. To get an idea of how badly the FPR at 10%, and even 20%, impinged on the beneficial diversification of pension portfolios note that in 1999, fully 85% of the major pension plans had more than 20% foreign exposure. In 2000 and 2001 the FPR was increased further to 30% in two 5 % point increments. Even so, at the end of 2001, 35% had foreign exposure greater than 30%. Finally, the FPR was eliminated in 2005.

Given the above brief history of the FPR one might view the pension industry in one of two ways: either it has, in the aggregate, subverted the legitimate ends of a valuable program, or it has provided guidance for the government on the major benefits that could be achieved by the removal of an outdated and inefficient program. In determining which

¹ This program began in the mid 1950's.

of these views is more valid, it was necessary to evaluate the costs and benefits of the FPR. If the costs of maintaining the FPR exceed the benefits from doing so, then the pension industry efforts can be viewed positively. In this note I will briefly review the arguments for and against the FPR and review what the evidence indicates. The likely consequences of the complete elimination of the FPR, and some unresolved issues that arise from that removal, are then addressed. Some concluding remarks are made in the final section.

Arguments Supporting a Continuing FPR

One of J. M. Keynes' statements in the *General Theory* (1936) that most bears on the issue of the FPR was: "Practical men, who believe themselves quite exempt from any intellectual influences, are usually the slaves of some defunct economist" (p.383). It would seem that Keynes and the economists who followed his writings were the "defunct economists" that provided the intellectual and ideological basis for the FPR. Two basic hypotheses formed the core of these economists' beliefs. First there was a general distrust of the efficacy of markets shaped primarily by the economic dysfunction of the Great Depression of the 1930s. The second hypothesis was that governments had both the ability and good will to undertake policies that would improve the welfare of the general public. Now, if markets poorly perform their role of allocating resources and the government is competent, then governments should play a significant role in the allocation of resources. The FPR can be seen as just that sort of benevolent guidance by the government.

What markets did the government find lacking that could justify the intrusion of the FPR? Two markets have been suggested – capital markets and the foreign exchange markets. With the FPR, Canadians would direct more of their savings toward domestic assets causing their yields to fall and decreasing the cost of capital. This would lead to greater domestic investment and an increase in income and ultimately employment. For the foreign exchange market the FPR would dampen capital outflows causing the Canadian dollar to be higher than it otherwise would be.

While these may sound like plausible stories that caused the government to implement the FPR, it should be noted that in 1971, there was a vigorous inflow of capital for new investment and that the Bank of Canada was doing everything in its power to keep the Canadian dollar from rising. This is not to say that the government did not anticipate that the regulation might be important in the future, but that presumes a degree of government foresight that has not historically been much in evidence. More likely was the belief at that time that the existence of *any* unemployment could be removed with a sufficient amount of increased demand for investment goods. Then, even with the net foreign investment, more investment would not hurt – and the government could always claim that it was through its beneficence that there was as much investment as possible.

There have also been undercurrents not directly linked to imperfect markets that may also have influenced the government's decision to resist the elimination of the foreign property rule. One of these was nationalism, where an interest group within the country

induces the government to use other peoples' money to crowd out foreign ownership with domestic owners. While difficult to find an economic rationale for this nationalism, at least one interpretation would be that domestic owners can be more easily coerced into following future government initiatives.²

A second undercurrent that gained some currency during the period of high government deficits and the attempts to reduce them was that the tax expenditures associated with tax deferred savings plans were quite high in terms of government cash flow³. These tax expenditures were also perceived to go primarily to the wealthy. The FPR could be seen either as an attempt to transfer some of those benefits to lower income groups or, more cynically, to throw sand in the workings of these tax-deferred plans by making them less attractive.

Arguments to Eliminate the FPR

Before examining the evidence, one might argue that those persons favoring the elimination of the FPR also followed defunct economists. In this case those economists would be Adam Smith and Leon Walras⁴, both of whom stressed the benefits and effectiveness of markets. Financial markets are seen as particularly efficient. Thus the cost of capital will, for all practical purposes, be unaffected by the existence or removal of the FPR. For suppose some Canadian saving left the country. Then if asset prices fell and rates of interest rose the returns would become more attractive to non-residents who would bring money into the country and finance the same level of investment. In equity markets this is even more evident since nearly 500 Canadian securities are dual listed on both Canadian and U.S. markets. These are substitutes for the single listed stocks that only trade on Canadian markets. As a result any change in prices of these later securities both Canadians and non-residents will arbitrage across markets until prices are once more in line. As globalization increases this becomes even truer in the sense that essentially there is no measurable change in price before arbitrage brings about equilibrium.

The foreign exchange market is also large and efficient, with over 50 billion dollars trading volume daily in the Canadian dollar alone. Furthermore, there are good reasons to believe that not all purchases of foreign securities create a *net* capital outflow. In particular, if a Canadian investor decides to purchase a foreign asset and hedge the proceeds back into Canadian dollars, the very act of hedging creates an equal and offsetting capital inflow. Indeed the only net capital flows generated by foreign purchases from a tax deferred savings plan will be those that are unhedged. The decision to hedge is primarily a bet on one's currency versus foreign currencies and that depends first and foremost on the behavior of the Bank of Canada relative to foreign central banks. It has

² An alternative interpretation is that this group believes that Canadian capitalists are kinder and gentler than their U.S. counterpart. However, many of those arguing this also seem to believe that all capitalists are evil.

³ The cash flow measure reflects the net increase in plan contributions. On a net present value basis, that also takes into account future taxes, the magnitude is roughly half the tax expenditure of the cash flow measure. See Burgess and Fried (2002) and Department of Finance (2002).

⁴ Leon Walras is often regarded as the father of general equilibrium theory in economics.

little if anything to do with the location of the financial assets those individual savers had chosen to hold.

There is an additional element that suggests that removing the FPR would lead to an *appreciation* of the Canadian dollar rather than a decrease. Work by Bartolini and Drazen (1997) suggests that in the past when countries eliminated capital controls on their own citizens there was a capital *inflow* rather than the expected outflow. The logic for this is that when a country decides to use markets and the rule of law, it signals to non-residents that the government is treating its own citizens better so it will treat non-residents better as well. In effect the political uncertainty premium declines.

Not only do opponents of the FPR believe that markets solve the problems that concern FPR advocates at least as well as government mandate, the unintended consequence of the FPR is that it represents a tax on workers and decreases the effective wage of lower income groups relative to the wealthier members of society. To see this, note that tax deferred savings is linked to earned income. Further, the effective wage consists of the wage *plus* benefits, including retirement benefits, and the FPR causes savers to accept a lower return for any given amount of risk bearing thereby lowering the value of benefits paid to the worker⁵

Evidence from past changes in the FPR

Twice over the last fifteen years the foreign property limit was increased, in the periods 1990-94 and 2000-01. These two periods provide at least some information on the consequences that might be expected when the FPR is eliminated.⁶ For one thing the exchange rate does not appear to be affected by the change in the FPR. Fried and Burgess (2002) use the Bank of Canada's forecasting model for the exchange rate and introduce a variable for those periods where the FPR was changed. The changes in the FPR had no statistically significant effect on the exchange rate⁷. Not only did funds hedge a significant proportion of their additional purchases of foreign assets which would have no net impact on the Canadian dollar but also the magnitude of the changes were so small as to strain credibility that any movement in the exchange rate occurred because of it. For instance, during 2000-01 we estimated that pension funds increased their foreign exposure by 50 billion dollars which amounted to roughly one day's trading volume for the Canadian dollar!

With respect to the cost of capital, the TSE outperformed other OECD markets during the 2000-01 period and relative to its rank in previous years when the FPR was unchanged at

⁵ Workers with RRSPs face a similar result: The wage income put into these instruments also earn a lower return for a given amount of risk bearing, increasing the cost of saving for retirement. This increased cost is the same as a decrease in the effective *real* wage.

⁶ See Fried and Wirick (1999) and Burgess and Fried (2002) for a more extended discussion of the empirical effects of the change in the FPR. The framework is that of Amano and van Norden (1993).

⁷ See Burgess and Fried (forthcoming) for information on the estimates.

20%. While this is anecdotal and does not confirm or contradict the impact of the FPR on the cost of capital, it does suggest that if the FPR did affect the cost of capital, its effect was small relative to other market factors.

The issue of who bore the cost of the FPR is also contentious: some arguing that it was the wealthy and others that it was the middle income groups. It turns out Statistics Canada (2001) published a recent monograph that indicates that the income group that has the greatest proportion of members who are in tax deferred savings plans are those with incomes of 30,000 to \$50,000. Those with incomes below that are either young - and expect their future income to be higher⁸ - or have low permanent incomes⁹. Furthermore, those with higher income generally have access to more sophisticated financial advice on how to avoid the costs of the FPR so, again, much of the cost of that specific legislation is borne by the middle class.

Those costs have been substantial. Fried and Wirick (1999) estimated the cost of the regulation when it was 20% amounted to \$3 billion to 6 billion dollars annually. In the follow-up study by Burgess and Fried (2002) the cost of maintaining the FPR at 30% was estimated to be \$1.5 billion to \$3 billion annually. Roughly one billion of these amounts represent the administrative costs due to enforcing the FPR and in reduced competition. The rest are the gains due to improved diversification measured as the increase in expected return for the same level of risk. To put these amounts in context, the Department of Finance (2001) estimates that the tax expenditure associated with tax deferred savings plans is roughly \$7.5 billion. Removing the 30% maximum would then increase the benefits of these plans by between 20% and 40%.¹⁰ Such an increase in “productivity” would be outstanding in either the public or the private sector!

In summary then, markets appear capable of absorbing any change in the FPR, including its complete removal with little if any impact on the exchange rate or the cost of capital. Further, the incidence of the FPR seems to be middle class savers rather than the wealthy, and these costs can be substantial. While some elements of the Canadian economy may suffer, most of the costs are simply dead weight losses to Canadian investors.¹¹ Those who might lose from the removal of the FPR would tend to be in the financial industry—the lawyers and derivative specialists who are employed to find legal means to get around pension regulation, and portfolio managers who have faced less competition than otherwise because the FPR acted as a barrier to entry for non-Canadian managers. The other group who might find themselves worse off is the “social engineers” who believe they know better than the average Canadian what is best for us, and use regulations such as the FPR to restrict our choices. The principle gainers will be the average Canadian worker who uses a tax deferred savings plan, whether it is held directly in an RRSP, or

⁸ For this group, tax averaging opportunities with tax deferred plans suggest savings should occur later in life.

⁹ In this case, any savings that are undertaken face a marginal tax rate of about 80% due to claw-backs on OAS and are provided a reasonable level of retirement income from GIS, OAS and CPP/QPP relative to their pre-retirement income.

¹⁰ See Burgess and Fried (2004).

¹¹ It may be that one of the few “free lunches” is that which comes from diversification.

indirectly through a company pension plan. Other gainers will be sponsors and workers who will share in the increase in the effective wage including benefits and, ultimately, anyone investing outside a tax deferred plan that uses mutual funds as their investment vehicle.

Consequences of Eliminating the FPR

It is easiest to begin by describing what *will not* happen with the elimination of the FPR. Not only does past evidence indicate that markets have operated quite well but also, for most pension plans, recent polls suggest that there is no intention to make any substantial changes in their portfolio stance in response to the elimination.¹² These polls also indicate that the median pension fund will increase its foreign property from the mid 20% - 30% level to the 30% - 40% level. This in turn suggests that the change in foreign property will be of the same magnitude as was the move when the FPR was changed from 20% to 30%. Pension funds are not noted for rushing into deciding or acting on any major portfolio shift, and moving to greater holdings of foreign property is no exception. Thus, past experience suggests there will be little or no impact on either the exchange rate or the average cost of capital. That does not mean that the relative prices of all stocks traded will be unaffected. In those sectors where one or two firms dominate the sector, Canadian funds may choose to diversify more broadly and their mandates permit this. Too, what will also *not* happen is a potential problem that was just waiting to happen with the FPR in place. This would have been the impact of CPP on the equity market. The CPP will continue to experience net cash inflows for the next decade and, as of 1999, has had the flexibility to hold equities. What it has said it will not do, unlike most large Canadian plans, is to have foreign *exposure* greater than the nominal limit set by the FPR. Under this policy it could well grow to have a dominant position in Canadian public and private equity markets with several hundred billion dollars concentrated there. Not only would the CPP investment board feel uncomfortable in such a situation, capital market participants would as well. It would be, after all, no honor to be known as just behind China in terms of government ownership of the means of production.

One change in capital markets that should occur over time is the further consolidation of financial firms, particularly those providing retail mutual funds. Currently the FPR is surely responsible for much of the high relative costs of these funds for at least two reasons. First it represents an administrative burden. For instance with the elimination of the FPR, the rationale for clone funds disappears. Given the \$27 billion in those funds at the end of 2004, and an average excess MER charged on them of roughly 40 basis points, their disappearance reduces the expenses of international funds by at least \$100 million annually. Moreover, to the extent that demand for non-Canadian funds was suppressed by the FPR, there was a disincentive for foreign suppliers to enter the Canadian market.¹³ As international funds become more attractive to supply, it will lead to the development of alliances and/or mergers between Canadian managers and foreign managers. Over time

¹² Results from an AON Consulting poll of clients, 2005.

¹³ It seems reasonable to suppose that the home country firm has an informational advantage in its local market.

scale economies will begin to be realized and costs fall, especially in response to increased competition.¹⁴

One area where there will be significant change for virtually all sponsors is in the responsibilities of pension boards. Removing the FPR increases the opportunities to earn a greater risk adjusted return for sponsor and members alike. To not even explore these opportunities is to be remiss in doing one's fiduciary duty. Questions that must be addressed include the extent to which foreign derivatives should be changed to cash positions, changes from passive foreign derivative portfolios to actively managed foreign accounts, and the extent to which portfolios should be hedged. No simple answers exist at this stage. For instance it is estimated that the cost of a derivative position in the S&P 500 index is roughly 5 basis points above that of a cash position. However, if you want the S&P hedged, it would require a currency hedge with the cash position but not necessarily with the derivative alternative. Further, outside North America there are tax considerations that could make derivatives a lower cost source for passive funds.

Foreign currency exposure is also not a simple question. For DB plans, the administrator might choose to have a foreign currency manager who provides a wrap on foreign (and domestic¹⁵) assets. As an alternative the foreign currency exposure could be integrated with exports and imports of the sponsoring firm which could generate economies by reducing total forward currency activity. For DC plans, there is both an issue of information and of choice. In terms of information, it is important that individuals should be informed that simply having all assets hedged into domestic currency does not free one of currency risk per se. Having some foreign currency exposure may well reduce the risks to a retired worker given that some of his retirement expenditures will be in terms of foreign exchange.¹⁶ Of course, if one only offers hedged products to members then the information burden will be eased, but at the expense of increased exposure to lawsuits.¹⁷

A more immediate issue for pension boards is in assessing the structure of fund offerings, including so called Canadian funds. If one thinks about it, one of the more bizarre of preliminary screens for choosing securities is the country in which the headquarters of the firm are located. Yet that is what we have been subject to over the last 35 years. Without a constraint saying pension plans must have 70% of their assets in that specific 3% of the world market, it should be time to rethink what a better "Canadian" screen should be.

¹⁴ This process has already begun. An example is the sale of RT Capital to UBS in 2000 shortly after the FPR was to be increased to 30%.

¹⁵ It is said, only partly in jest, that US capital markets are so good because their banking laws were so bad. Canadians may be in a similar position where we have a comparative advantage in using derivative contracts because the FPR was so bad. One thing every pension administrator has learned is that the foreign exposure is quite separate from foreign property. This currency exposure and the currency of the foreign property can also be treated quite separately.

¹⁶ In counseling the retiring member it might be useful to begin with the question: How much time do you intend to spend playing golf in Florida, touring Italy and/or shopping in Hong Kong? Having some exposure to U.S. dollars and/or Euros then has some immediacy to the retiree.

¹⁷ Take the case of a potentially nasty divorce between Quebec and the rest of Canada. And you didn't offer members a mechanism to move their retirement savings out of Canadian dollars?

More specifically, how should the benchmark for what are now called Canadian equity funds be structured? While this is best developed in negotiations with the plan's Canadian managers, having some idea of the alternatives before those negotiations begin is useful.

One alternative that is fairly close to the current strategy could be those securities that trade, or have traded on Canadian markets over the last several years. That would continue to incorporate all the securities eligible under the past regime plus some firms that were formerly part of that set but have since been merged with, or been taken over by, some foreign entity. The benchmark could continue to be the TSX with or without some minor adjustments. Such an extension would implicitly suppose that there are economies in having informational advantages that come from local connections. Another choice could be all securities that trade in Canadian dollars. This would remove some securities that trade on the Canadian exchanges in US funds. It is also quite arbitrary in that one can always have effective Canadian dollar exposure through hedging.

A third alternative would draw on a basic principle used for DB plans, or more specifically for suppliers of annuities, namely liability matching. For annuities the "risk free" portfolio is one that matches the duration of the assets with the duration of the liabilities. When considering the world equity market, the appropriate liability matching would be approximated by the mix of assets that is highly correlated with the consumption bundle of the annuitant. The TSE is more correlated with the *production* of Canadians than with their *consumption*. Since perhaps 40% of Canadian consumption is from imports directly or as intermediate goods embedded in Canadian consumption a more appropriate benchmark would incorporate roughly that proportion of foreign assets. Specifically, the benchmark would have sector weights that correspond to Canadian consumption patterns and would be composed of firms that supply Canadians with these goods.¹⁸

Concluding Remarks

The foreign property rule for tax deferred savings plans is a government regulation that has long outlived any usefulness it might have had when it was instituted. As with many such laws and regulations, it has been extremely difficult to eliminate it after it has outlived its usefulness. What has ultimately led to its repeal is the fact that previous governments have partially eased it on two occasions which provided the evidence that it was not producing the benefits advocates asserted it would. Specifically, it has not improved the value of the Canadian dollar. It has not decreased the cost of capital. It has not represented a means to reduce tax benefits to the wealthy. Rather it has represented a tax on workers. It has prevented efficient portfolio diversification for middle income

¹⁸ In allocating pension wealth it is important to address the issue of human capital as one implicit asset in the portfolio. If the manager does decide that human capital does have a role, it will turn out that the amount of foreign exposure in the *pension* portfolio will have a considerably greater weight than simply the import share. See, for example, Baxter and Jermann (1997) or Bodie, Merton, and Samuelson (1992).

savers. It has enriched certain members of the legal and financial community by increasing compliance costs and reducing international competition. Its complete elimination with the 2005 budget should be welcome news for all Canadian workers and savers.

The magnitude of the additional accumulation of foreign property due to the elimination of the FPR is expected to be of roughly the same magnitude as that accompanying the previous increases in the FPR from 10% to 20% and 20% to 30%, and will be easily absorbed by financial and foreign exchange markets. It will also, fortuitously, remove a potential problem for Canadian capital markets of an increasing presence of the CPP that could have lead to a substantial decrease in the liquidity of the Toronto market.

The removal of the FPR provides sponsors and pension administrators increased opportunities to enhance pension savings for plan members. It also means increased responsibilities in doing one's fiduciary duties. Whatever the outcome, decisions must be made regarding such questions as the extent that foreign currencies should be represented in the portfolio, how Canadian fund mandates may usefully be altered and what might be appropriate benchmarks in this new environment.

Choosing a benchmark for the Canadian manager is, in fact, only an interim measure. Over the longer term the question is will there be *any* funds that will represent regions? The movement away from an emphasis on country weightings and toward analyzing firms by sector irrespective of location is already well underway in both EAFE and global mandates. While the relevant MSCI indexes may serve as a benchmark in assessing a specific manager, the Canadian "consumption index" mentioned above is the relevant one for the overall pension portfolio. There might still be a manager with a "Canadian" screen but that would be less important than country irrelevant screens for value, growth, large and small cap, etc.

The Foreign Property Rule has been the primary government imposed quantitative restriction on pension plans for almost one half century. Its genesis was founded on the belief that government rules were necessary for the proper allocation of resources. Over time that belief has been brought more and more into question. Pension boards have persistently violated its spirit, if not the letter, of the law in an attempt to do their fiduciary duty for plan members. Finally the rule has been eliminated with the recognition that markets do indeed operate efficiently and that pension plans appear to act in their members' interest despite regulations that are the antithesis of the fiduciary duties asked of plan sponsors and administrators. But the FPR is but one of many regulations limiting choices of pension plans and, more broadly, Capital Accumulation Plans in general. Looking at those quantitative restrictions across financial institutions providing essentially the same products is an exercise in wonderland: they make little if any sense especially given what has been learned from the costly exercise with the FPR. Elimination of the FPR perhaps provides the hope that these other quantitative restrictions can also be lifted, and the government has the humility to recognize that markets, rather than government imposed arbitrary regulations, can make all Canadians better off.

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